(2)

Supreme Court, U.S.
FILED
DEC 11 1992
OFFICE OF THE CLERK

No. 92-829

In The

Supreme Court of the United States

October Term, 1992

MOUNTAIN WATER CO.,

Petitioner,

v.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, et al.,

Respondents.

Petition For A Writ Of Certiorari To The Supreme Court Of The State Of Montana

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

ROBIN A. MCHUGH
Special Assistant Attorney General
Montana Department of Public Service Regulation
Montana Public Service Commission
P.O. Box 202601
1701 Prospect Avenue
Helena, MT 59620-2601
(406) 444-6376
Attorney for Montana Department of Public Service Regulation

MARY WRIGHT*
Special Assistant Attorney General
Montana Consumer Counsel
34 West Sixth Avenue
Helena, MT 59620-1703
(406) 444-2771
Attorney for Montana Consumer Counsel
**Counsel of Record*

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

58 pp

QUESTIONS PRESENTED

1. Whether the Montana Supreme Court was in error by holding that the Montana Public Service Commission did not violate the fourteenth amendment's requirement of just compensation for property taken for public use when it denied Mountain Water Company certain compensation for money taken by a state statute on the ground that granting compensation through rates would violate the rule against retroactive ratemaking.

2. Whether there is any basis for this Court "to protect the integrity of the federal judicial process" from actions of the Montana Supreme Court or the Montana Public Service Commission.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

TABLE OF AUTHORITIES iv

OPINION BELOW 1

JURISDICTION 1

STATEMENT 1

SUMMARY OF THE ARGUMENT 3

ARGUMENT 5

THIS PETITION PRESENTS NO CONFLICT BETWEEN THE MONTANA SUPREME COURT AND THE NINTH CIRCUIT COURT OF APPEALS OVER A FEDERAL QUESTION 5

THIS COURT'S HOLDING IN *FIRST ENGLISH* DOES NOT CONFLICT WITH THE DECISION BY THE MONTANA SUPREME COURT 10

THIS COURT'S "AFFIRMATIVE ROLE" IN THE FEDERAL JUDICIAL PROCESS DOES NOT EXTEND TO SUPERVISION OF THE MONTANA SUPREME COURT; THERE HAS BEEN NO UNDERMINING OF THE INTEGRITY OF THE FEDERAL JUDICIAL PROCESS IN THIS CASE .. 13

CONCLUSION 17

TABLE OF CONTENTS – Continued

Page

APPENDIX

1. Excerpt of Brief of Appellee, Department of Public Service Regulation, Montana Public Service Commission in *Mountain Water Company v. Montana Department of Public Service Regulation, Montana Public Service Commission,* United States Court of Appeals for the Ninth Circuit CA No. 88-4097 ..... 1a

2. Excerpt of Brief of Defendant-Appellant Montana Public Service Commission in *Mountain Water Company v. Montana Department of Public Service Regulation, Montana Public Service Commission, and Montana Consumer Counsel,* Montana Supreme Court No. 91-446 ..... 17a

3. Excerpt of Reply Brief of Defendant-Appellant Montana Public Service Commission in *Mountain Water Company v. Montana Department of Public Service Regulation, Montana Public Service Commission, and Montana Consumer Counsel,* Montana Supreme Court No. 91-446 ..... 29a

TABLE OF AUTHORITIES

Page

CASES

Board of Public Utility Commissioners v. New York Telephone Co., 271 U.S. 23 (1926) 9

Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) 7, 8, 11

First English Lutheran Evangelical Church v. Los Angeles County, 482 U.S. 304 (1987) ..... *passim*

Frazier v. Heebe, 482 U.S. 641 (1987) 4, 14

Galveston Electric Co. v. Galveston, 258 U.S. 388 (1922) 8, 9

In re Ruffalo, 390 U.S. 544 (1968) 14

Mountain Water Company v. Montana Department of Public Service Regulation, 919 F.2d 593 (9th Cir. 1990) ..... *passim*

Mountain Water Company v. Montana Department of Public Service Regulation and Montana Consumer Counsel, 835 P.2d 4 (1992) ..... *passim*

STATUTES

United States Code

28 U.S.C. § 1257(a) 1

28 U.S.C. § 2072 14

Montana Code Annotated

Section 69-4-511 ..... *passim*

OPINION BELOW

The opinion of the Montana Supreme Court, (Pet. App. 1-5), is reported at 835 P.2d 4 (1992).

JURISDICTION

The judgment of the Montana Supreme Court was entered on July 21, 1992. (Pet. App. 6.) A petition for rehearing was denied on August 13, 1992. (Pet. App. 92.) The petition for a writ of certiorari was filed on November 12, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

STATEMENT

Mountain Water Company (hereinafter "Mountain Water") is a private water utility regulated by the Montana Public Service Commission (hereinafter "PSC"). (Pet. App. 195.) In 1987 the Montana legislature passed Mont. Code Ann. § 69-4-511, requiring private water utilities to pay part of the cost to maintain that portion of customer service lines that runs from the water main to the customer property line. (Pet. 3-4.) In response, Mountain Water filed for declaratory judgment in United States District Court for the District of Montana, seeking declaration that Mont. Code Ann. § 69-4-511, *inter alia*, violates the fourteenth amendment by taking the property of Mountain Water without just compensation. (Pet. App. 81.) The district court held that the statute does not constitute a prohibited taking but that it does impose a

service obligation on private water utilities, "for which [they] will be compensated by an increase in rates if necessary." (Pet. App. 86.)

Mountain Water appealed the decision of the district court to the Court of Appeals for the Ninth Circuit. The court of appeals affirmed, holding that Mont. Code Ann. § 69-4-511 effects a taking of Mountain Water's property, but that in the special context of public utility law compensation comes through the ratemaking process: "Any failure of a rate order to compensate Mountain Water justly for expenses incurred under the liability statute would make the rate order, but not the statute, unconstitutional." (Pet. App. 79.)

In 1989 Mountain Water filed a general rate case with the PSC, including a request to be compensated through rates for expenses incurred in complying with Mont. Code Ann. § 69-4-511. The PSC granted Mountain Water's request to include on-going compliance costs in rates on a prospective basis. The PSC denied Mountain Water's request to include prior period compliance costs in rates on the grounds that granting the request would constitute a violation of the prohibition against retroactive ratemaking. (Pet. App. 28-35.) Mountain Water appealed the PSC decision to the Montana First Judicial District Court. The district court reversed the PSC, finding that the refusal to include prior period compliance costs did not justly compensate Mountain Water for the taking. (Pet. App. 12-18.) The PSC and the Montana Consumer Counsel appealed and the Montana Supreme Court reversed, upholding the rule against retroactive ratemaking and finding that Mountain Water was justly compensated through ratemaking for costs incurred in complying with Mont.

Code Ann. § 69-4-511. (Pet. App. 1, 5.) Mountain Water asks this Court to review this decision of the Montana Supreme Court.

SUMMARY OF THE ARGUMENT

There is no conflict between *Mountain Water I* and *Mountain Water II*.[1] In *Mountain Water I* the court held that Mont. Code Ann. § 69-4-511 does not impose an uncompensated taking; just compensation comes through rate setting. In *Mountain Water II* the court held that the PSC had justly compensated Mountain Water for costs incurred complying with Mont. Code Ann. § 69-4-511; the court held that just compensation does not include retroactive recovery of prior period expenses. In reaching its decision in *Mountain Water II* the court was consistent with its own precedent as well as precedent established by this Court on the Takings Clause in the special context of public utility law.

Mountain Water argues that this Court should grant the requested writ because the decision of the Montana Supreme Court conflicts with *First English Evangelical Lutheran Church v. Los Angeles County*, 482 U.S. 304 (1987). In *First English* the Court decided a narrow issue of law:

---

[1] In its Petition Mountain Water designated *Mountain Water Company vs. Montana Department of Public Service Regulation*, 919 F.2d 593 (9th Cir. 1990) as "Mountain Water I" and *Mountain Water Company vs. Montana Department of Public Service Regulation, Montana Public Service Commission and Montana Consumer Counsel*, 835 P.2d 4 (1992) as "Mountain Water II." In order to be consistent these designations will also be used in this brief.

just compensation requires compensation for property taken by a land use regulation for the period of time before the regulation has been adjudicated a taking. On the other hand, previous holdings of this Court require compensation through the ratemaking process for takings of public utility property. The Montana Supreme Court properly applied these holdings, and thus there is no conflict between this Court's holding in *First English* and the Montana Supreme Court's decision in *Mountain Water II*. Mountain Water is not entitled to dollar-for-dollar eminent domain type compensation for its costs of complying with Mont. Code Ann. § 69-4-511.

Mountain Water urges this Court to grant the writ to protect the integrity of the federal judicial process. It argues that certain statements made by the PSC before the federal district court and the court of appeals bound it to a particular ratemaking method which it subsequently did not apply. No statements made in the lower federal courts, however, contained any promise of a particular ratemaking treatment or in any way disrupted the integrity of the federal judicial process. The precedent cited in Mountain Water's petition, *Frazier v. Heebe*, 482 U.S. 641 (1987), applies to this Court's supervisory powers over lower federal courts, and does not extend to supervision of a state supreme court.

ARGUMENT

THIS PETITION PRESENTS NO CONFLICT BETWEEN THE MONTANA SUPREME COURT AND THE NINTH CIRCUIT COURT OF APPEALS OVER A FEDERAL QUESTION

In *Mountain Water I* the issue relevant to this petition was whether Mont. Code Ann. § 69-4-511 imposes a taking without just compensation in violation of the fifth and fourteenth amendments. The court of appeals concluded that it did not, finding that while the statute imposes a taking in the form of a utility service obligation, just compensation comes through PSC ratemaking. The court of appeals further concluded that failure to compensate justly for expenses incurred under the statute would make the rate order, but not the statute, unconstitutional. *Mountain Water I*, 919 F.2d at 600-601. (Pet. App. 77-79.)

The statute was not at issue in *Mountain Water II*; rather, the issue was whether a PSC rate order adequately compensated Mountain Water for its expenses incurred under the statute. The Montana Supreme Court ruled that it did. Because *Mountain Water I* and *Mountain Water II* do not contain holdings on the same issue there can be no conflict in the decisions; thus, one of Mountain Water's arguments for granting certiorari is eliminated.

Mountain Water manufactures a conflict in the two cases by reading selectively from *Mountain Water I* and misstating the holding of that case. Mountain Water emphasizes the following language from the court of appeals: "Only if the PSC's rate order fails to compensate

Mountain Water justly for all of its private property dedicated to public use can Mountain Water complain of a violation of its fifth amendment rights." *Mountain Water I*, 919 F.2d at 600. (Pet. App. 78.) Mountain Water interprets the word "all" in this sentence as indicating a holding that just compensation requires recovery through rates of all property taken, notwithstanding the prohibition against retroactive ratemaking. Because the Montana Supreme Court affirmed the PSC's refusal to authorize retroactive recovery of Mont. Code Ann. § 69-4-511 expenses, Mountain Water posits a conflict between *Mountain Water I* and *Mountain Water II*. There are several problems with this argument.

First, the discussion in *Mountain Water I* of the requirements of just compensation in the context of public utility regulation is dicta. The holding of the case on the fourteenth amendment question is simply, 1) Mont. Code Ann. § 69-4-511 imposes a taking for a public use, and 2) just compensation is determined in the ratemaking process. Second, the dicta on the requirements of just compensation in *Mountain Water I* are fully in accord with the conclusions of the Montana Supreme Court in *Mountain Water II*. The court of appeals notes Mountain Water's argument that a taking in the public utility context requires compensation consistent with a typical eminent domain action – and rejects it. The court writes,

> Under Mountain Water's analysis then, the liability statute's taking of these funds necessitates a judicial eminent domain action, just as the taking of a parcel of land would so necessitate. Unlike judicial eminent domain proceedings, Mountain Water points out, PSC rate setting is

> prospective. PSC rate setting therefore, cannot compensate Mountain Water dollar-for-dollar for the funds the utility must transfer to its customers.

Mountain Water I, 919 F.2d at 600. And the court concludes " . . . we note that utilities often in some sense share their accumulated profits with customers when utilities fail to achieve their authorized returns. Indeed, Mountain Water's 'losses' under the liability statute are not constitutionally significant unless its set rates are 'unjust.' " *Id.* at 601. This is an explicit recognition of the prohibition against retroactive ratemaking and of the fact that just compensation in the context of public utility law does not require dollar-for-dollar recovery for property taken.

Third, it is instructive to note that the court in *Mountain Water I* cites several times to *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). In *Duquesne* this Court was faced with the constitutionality of a Pennsylvania statute that prevented certain prudent utility planning costs from inclusion in rates. Even though the statute made it impossible for all property taken to be specifically recovered in rates, the Court found it constitutional, stating that the only relevant constitutional question is whether a rate order allows a utility to earn a reasonable return on its property devoted to utility service. *Id.* at 307-314. The Court held that individual cost items within a rate case (such as compliance with Mont. Code Ann. § 69-4-511) do not have constitutional dimension. *Id.* In *Mountain Water II* it was not questioned that the PSC rate order gave Mountain Water the opportunity to earn a reasonable rate of return. (Pet. App. 23-25.) Thus, the court's decision in

Mountain Water II is consistent with this Court's decision in *Duquesne*.

In light of the above, Mountain Water's interpretation of *Mountain Water I* is untenable. To give the meaning that Mountain Water suggests to the phrase "compensate . . . justly for *all* of its property dedicated to public use . . . " (emphasis added) would be 1) inconsistent with the totality of the fourteenth amendment discussion in *Mountain Water I* itself, 2) inconsistent with *Duquesne*, and 3) inconsistent with other decisions of this Court as discussed below.

The real issue that Mountain Water raises, in the guise of asserting a conflict between *Mountain Water I* and *Mountain Water II*, is whether the prohibition against retroactive ratemaking is consistent with the fourteenth amendment. As the court of appeals recognized in *Mountain Water I*, the answer is yes. If the answer were to be no, then numerous opinions of this Court and lower courts would be overturned, and the regulation of public utilities, as practiced for over a century, would be radically changed.

This issue was settled long ago, and Mountain Water has provided no reason for this Court to revisit it. In *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 395 (1922) (emphasis added), the Court wrote,

> A company which has failed to secure from year to year sufficient earnings to keep the investment unimpaired and to pay a fair return, whether its failure was the result of imprudence in engaging in the enterprise, or of errors in management, or of omission to exact proper

> prices for its output, *cannot erect out of past deficits a legal basis for holding confiscatory for the future, rates which would, on the basis of present reproduction values, otherwise be compensatory.*

In *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23, 31-32 (1926) (emphasis added), this Court reiterated,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. *If there is no return, or if the amount is less than a reasonable return, the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations.

These cases dispose of the issue. The Montana Supreme Court has relied on *Galveston* and has established the prohibition against retroactive ratemaking as a rule of law. *Mountain Water II*, 835 P.2d at 6, and Montana cases cited by PSC at Appendix 23a-24a. Mountain Water repeatedly mischaracterizes the rule against retroactive ratemaking as a "policy." (Pet. 15-16.) The prohibition against retroactive ratemaking is not a discretionary policy, it is the law. The decision in *Mountain Water II* was an easy, straightforward application of the law to the facts. It does not warrant further review.[2]

---

[2] In both state and federal courts the PSC extensively briefed retroactive ratemaking and the taking issue in the con-

THIS COURT'S HOLDING IN *FIRST ENGLISH* DOES NOT CONFLICT WITH THE DECISION BY THE MONTANA SUPREME COURT

Mountain Water argues that the Court should grant the writ in this case because the decision of the Montana Supreme Court conflicts with this Court's holding in *First English Evangelical Lutheran Church v. Los Angeles County*, 482 U.S. 304 (1987). Mountain Water states that this Court held in that case that compensation must be paid for past economic losses which amount to a taking and which are incurred as a result of state statutory law. Mountain Water also states that the Montana Supreme Court "ignored" *First English* and denied compensation even though the statute in question had been adjudicated a taking requiring compensation under the fourteenth amendment. (Pet. 11.)

If the Montana Supreme Court "ignored" this Court's holding in *First English*, it may be because Mountain Water did not bring the case to the attention of the court. *First English* was not raised before the Montana Supreme Court, or, for that matter, before any of the lower courts, either state or federal. If that case had been raised before the Montana Supreme Court, however, it would not have changed the outcome.

The reason why *First English* would not have changed the Montana Supreme Court's decision in *Mountain Water II* is that it is simply not applicable to Mountain Water's situation. In *First English*, this Court decided

---

text of public utility law. Two of these briefs are attached at Appendix 1a and 17a. Mont. Code Ann. § 69-4-511 is referred to as "S.B. 28" in the brief to the Montana Supreme Court.

a narrow issue, that is, that the just compensation clause requires compensation for property taken by a land use regulation for that period of time before it is determined that the regulation is a taking.

Mountain Water attempts an analogy between the State of California's position in *First English* and that of the State of Montana in this case. It points out that the California courts believed that compensation for a taking did not need to be paid for the period prior to adjudication of a taking because of important policy considerations. (Pet. 17-18.) This Court rejected that position, holding that where the government's activities have worked a taking, no subsequent government action can relieve it of the duty to provide compensation. 482 U.S. at 321. In *Mountain Water II*, according to Mountain Water, the State of Montana has taken its property and deprived it of compensation on the basis of state policy, that is, the "general policy" against retroactive ratemaking. This analogy fails.

The rule against retroactive ratemaking is a rule of law, and cannot be applied at the discretion of the PSC. In addition, the rule is consistent with the fifth and fourteenth amendments, as applied in the public utility context, and as found in *Mountain Water I* and *Duquesne*. Mountain Water argues that *Duquesne* and the traditional public utility takings clause cases cannot "save" the Montana Supreme Court's decision in *Mountain Water II* because the *Duquesne*-type analysis is intended to determine *whether* a taking has occurred, while in this case the taking has already been adjudicated. (Pet. 18-19.)

There is nothing special about the costs imposed by Mont. Code Ann. § 69-4-511, except that Mountain Water took the trouble to have them adjudicated a taking. The PSC never argued that the statute did not take Mountain Water's property. Because state law requires public utilities to provide reasonably adequate service, a utility could have any of its costs of service declared takings and under Mountain Water's theory, have them compensated for other than through the ratemaking process. Costs imposed by Mont. Code Ann. § 69-4-511 are no different than any other costs incurred by Mountain Water. There is simply no reason to treat them as typical eminent domain type takings and require compensation other than through the ratemaking process.

The very case in which Mountain Water's compliance costs were declared a taking recognizes the proper means of compensating Mountain Water for those costs. In *Mountain Water I*, the ninth circuit rejected Mountain Water's attempt to distinguish its case from traditional fifth amendment public utility cases, and stated that the fact that Mountain Water had to seek compensation through PSC rate setting rather than through eminent domain was not of constitutional significance. It also stated that any potential "losses" on the part of Mountain Water under Mont. Code Ann. § 69-4-511 are not constitutionally significant unless its set rates are unjust. (Pet. App. 77-79.) Mountain Water, of course, has never challenged its set rates.

The court of appeals and the Montana Supreme Court have correctly determined that Mountain Water is not entitled to compensation other than through the traditional ratemaking process. The Montana Supreme

Court correctly concluded that rates set by the PSC must be at a level that allows just compensation for any regulation that impairs a utility's property interest. (Pet. App. 3.) Mountain Water is not entitled to typical eminent domain type compensation. The narrow holding of this Court in *First English* is not applicable to costs incurred in compliance with Mont. Code Ann. § 69-4-511, which the Montana Supreme Court correctly determined were to be treated in the traditional ratemaking process. This Court's holding in *First English* does not support granting the writ.

THIS COURT'S "AFFIRMATIVE ROLE" IN THE FEDERAL JUDICIAL PROCESS DOES NOT EXTEND TO SUPERVISION OF THE MONTANA SUPREME COURT; THERE HAS BEEN NO UNDERMINING OF THE INTEGRITY OF THE FEDERAL JUDICIAL PROCESS IN THIS CASE

Mountain Water's third reason given to the Court for granting the writ is that it has an "affirmative role to play in preventing the undermining of the integrity of the federal judicial process." It states that the Court must reverse the Montana Supreme Court's decision if the integrity of the federal judicial process is to be vindicated. (Pet. 22.) In support, Mountain Water alleges that the PSC represented to the federal courts that Mountain Water would be compensated for its compliance costs in the ratemaking process, and that the courts relied on those representations in upholding the validity of the statute. Mountain Water goes on to say that the PSC's "general policy" against retroactive ratemaking was in existence at the time the representations were made in the

federal courts, and that other PSC rules made it impossible for Mountain Water to apply for a rate increase in time to recover the compliance costs in question. (Pet. 19-22.)

The only precedent cited in support of this Court's granting the writ to protect the federal judicial process is a portion of a footnote in *Frazier v. Heebe*, 482 U.S. 641 (1987): "The Court's supervisory power over federal courts allows the Court to intervene to protect the integrity of the federal system. . . . " 482 U.S. at 647 n.7. In *Frazier* the Court considered a lower court ruling upholding a local federal district court rule preventing admission to practice of an attorney who was a member of the state bar but had neither a residence nor an office within the jurisdiction. The Court noted that federal district courts have the discretion to adopt local rules, including rules governing admission to practice before them. Their discretion, however, has limits, including the U.S. Supreme Court's "inherent supervisory power to ensure that these local rules are consistent with 'the principles of right and justice.' *In re Ruffalo*, 390 U.S. 544, 554 (1968)[.]" (other citations omitted). 482 U.S. at 645.

This Court's jurisdiction in *Frazier* was also based upon 28 U.S.C. § 2072, which states: "The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings and motions, and the practice and procedure of the district courts . . . and courts of appeals of the United States in civil actions . . . . " 482 U.S. at 646 n.4. Thus, this Court in *Frazier* was dealing with its powers over lower federal courts in the limited area of practice and procedure. The Court stated, referring to its authority over matters such as rules for

admission to practice, that its authority over state court bars is limited to enforcing federal constitutional requirements. 482 U.S. at 647 n.7. Although this Court's authority to intervene in lower federal court matters to protect the integrity of the federal system is unquestioned, *Frazier* does not support Mountain Water's position that this Court should overturn a decision of a state supreme court for the same reason.

Mountain Water's charges with respect to statements by the PSC before the federal courts, their effect and the supposed conflict between the "general policy" against retroactive ratemaking and other PSC rules must also be addressed here, as they have been thoroughly and repeatedly before the lower courts. Mountain Water charges that the PSC promised the federal courts that Mountain Water would be compensated for all its property taken in compliance with Mont. Code Ann. § 69-4-511, and that the federal courts relied on the promise in reaching their decisions. Mountain Water asserts that the PSC then reneged on this promise by applying the "general policy" against retroactive ratemaking to deny Mountain Water prior period compliance costs. The PSC has responded exhaustively to these charges. (App. 30a-35a, and Pet. App. 29-35.) The Montana district court ignored the charges, (Pet. App. 18), and the Montana Supreme Court found them without merit. The court wrote as follows: "[Mountain Water] argues that the PSC is bound by judicial estoppel. The PSC admitted during the course of the federal litigation that [Mont. Code Ann. § 69-4-511] was a taking and that [Mountain Water] would be compensated through rate-making. However, in making that admission the PSC did not waive application of the rules involved in

rate-making." *Mountain Water II*, 835 P.2d at 6. (Pet. App. 3-4.) Thus, the PSC stands convicted of promising that property taken will be reflected in rates according to the rules of ratemaking. The PSC, of course, did exactly as it promised: it reflected compliance costs in rates according to the rules of ratemaking, which do not permit the recovery of prior period (retroactive) expenses. The federal courts did not rely on a PSC promise, because their decisions were not determined by anything the PSC might do, but to the extent the PSC made a promise to the federal courts, it fulfilled it.[3]

Mountain Water's repeated assertions that the statements made by the PSC to the federal courts constituted a promise of a particular ratemaking treatment simply are not accurate. Rather, the statements were simply straightforward characterizations of the ratemaking process.

Mountain Water was not placed in any sort of regulatory bind by conflicting PSC rules. Nor did the PSC promise any particular regulatory treatment. When

---

[3] Though it is of no consequence to this petition, the PSC disagrees with the Montana Supreme Court that it admitted or promised anything to the federal courts with respect to its ratemaking treatment of Mont. Code Ann. § 69-4-511 costs. This is because 1) such a promise or admission was not necessary or germane to the PSC's theory of the case, and 2) the PSC does not speak on rates except in an order following a hearing. However, the PSC certainly does not object to the conclusion of the Montana Supreme Court that the PSC promised to do its job according to law.

Mountain Water chose to wait until June of 1989 to apply for a rate increase, it took the risk of making a proposal to the PSC that could not be granted because of the prohibition against retroactive ratemaking. Nothing in the history of this case indicates that the PSC made misleading or inaccurate statements or promises, or any way disturbed the integrity of the federal judicial process. Neither *Frazier* nor the history of this case offers any reason why this Court should grant the writ sought by Mountain Water.

CONCLUSION

Mountain Water has failed to establish any reason why this Court should grant a writ of certiorari in this case. There is no conflict between the decisions of the Montana Supreme Court and the court of appeals. Nor does the holding of the Montana Supreme Court, which properly upheld the orders of the PSC determining compensation in the ratemaking process, conflict with *First English*. Nothing in the history of the case indicates any interference with the integrity of the federal judicial process or justifies overturning the decision of the Montana Supreme Court.

For these reasons, the PSC and the Montana Consumer Counsel respectfully ask that the writ sought by Mountain Water not issue.

Respectfully submitted this 14th day of December, 1992.

ROBIN A. MCHUGH
Special Assistant Attorney General
Montana Department of Public Service Regulation
Montana Public Service Commission
P.O. Box 202601
1701 Prospect Avenue
Helena, MT 59620-2601
(406) 444-6376
Attorney for Montana Department of Public Service Regulation

MARY WRIGHT*
Special Assistant Attorney General
Montana Consumer Counsel
34 West Sixth Avenue
Helena, MT 59620-1703
(406) 444-2771
Attorney for Montana Consumer Counsel

**Counsel of Record*

IN THE

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

* * *

MOUNTAIN WATER COMPANY, Plaintiff-Appellant, -vs- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, Defendants-Appellee.	)	CA NO. 88-4097

* * *

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MONTANA, HELENA DIVISION

* * *

BRIEF OF APPELLEE DEPARTMENT OF PUBLIC SERVICE REGULATION MONTANA PUBLIC SERVICE COMMISSION

* * *

ROBIN A. MCHUGH
STAFF ATTORNEY
DEPARTMENT OF PUBLIC SERVICE REGULATION
MONTANA PUBLIC SERVICE COMMISSION
2701 Prospect Avenue
Helena, Montana 59620
(406) 444-6376

* * *

II. SECTION 69-4-511 DOES NOT VIOLATE THE FIFTH AMENDMENT PROHIBITION AGAINST UNCOMPENSATED TAKINGS OF PRIVATE PROPERTY FOR A NONPUBLIC USE.

Section 69-4-511 requires private water utilities to pay part of the maintenance cost of a portion of the service lines connected to private utility water mains. Mountain Water argues that this requirement constitutes an uncompensated "taking" of private utility property for a nonpublic use. This argument is without merit.

A. Section 69-4-511 Does Not Mandate an Uncompensated "Taking" of Private Property.

For purposes of this discussion the relevant language from the fifth and fourteenth amendments is as follows:

> No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

U.S. Const. amend. V.

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law.

U.S. Const. amend. XIV, § 1. It has been long settled that the compensation clause of the fifth amendment has been incorporated into the fourteenth amendment. *Chicago, Burlington and Quincy R.R. Co. v. City of Chicago*, 166 U.S. 226 (1897), *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980). Therefore, Montana must provide compensation if it acts to "take" private property and such

"taking" is deemed an exercise of the eminent domain power. There can be "takings" under the general state police power for which there need be no compensation. Such "takings" are often accomplished under the general rubric of business regulation. However, in the context of public utility regulation, the state must provide adequate compensation through rates for the use of utility company property for the provision of utility service. Therefore, though the cases rarely speak in these terms, the "taking" of utility property for the provision of utility service is an exercise of eminent domain power and must be compensated (albeit indirectly) under the same principle that a property owner must be compensated if his property is "taken" for the construction of a highway.[11]

Historically, the Supreme Court has taken two conflicting positions on the "taking" issue. In *Mugler v. Kansas*, 123 U.S. 623 (1887), the Court declared that a state may regulate business through the exercise of the police power, but that such regulation does not constitute a "taking" unless property is actually appropriated for the public benefit. In *Pennsylvania Coal v. Mahon Co.*, 260 U.S. 393 (1922), the Court retreated from such a rigid position and held that regulation may impair property interests to such an extent as to constitute a "taking," even where there is not actual physical appropriation of the property. In this view, valid exercise of the police power may

---

[11] For an excellent capsule discussion of the "taking" issue see J. Nowak, R. Rotunda, J. Young, *Constitutional Law*, 2d Ed. 493 (1983) and 2 R. Rotunda, J. Nowak, J. Young, *Treatise on Constitutional Law*, § 15.12 (1986). Citation to authority supporting these general comments on "taking" will be made in the following discussion.

constrain property use sufficiently to be judged a "taking," and to require compensation.

There is no question that Montana may validly regulate the service and rates of public utilities, or that such regulation has the potential to constitute a "taking" in violation of the fifth and fourteenth amendments of the United States Constitution. However, it is equally apparent that the "taking" issue, in the context of public utility regulation, is not a question of adequate direct compensation for seizing property or impairing its use, but rather is a question of whether authorized rates provide sufficient revenue to generate a reasonable rate of return on plant devoted to utility service.

An early and important case in this area is *Smyth v. Ames*, 169 U.S. 466 (1897). *Smyth* involved the constitutionality of an act of the Nebraska legislature setting maximum rates to be charged by railroads for the transportation of freight within the State of Nebraska. The Court held that while the State of Nebraska had the power to regulate railroad rates, it could not do so in such a manner as to amount to a taking of private property for public use without just compensation. The Court further held that, though it is not the business of the courts to set initial rates, a determination of whether those rates amount to a deprivation of property is a proper subject of judicial inquiry. *Id.* 169 U.S. at 522-526.

In a later case the United States Supreme Court heard an appeal from the Supreme Court of West Virginia which had upheld an order of the West Virginia Public Service Commission over objections that rates set by the Commission were confiscatory in violation of the fourteenth

amendment. *Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679 (1923). The Court in *Bluefield* stated the following:

> The question in the case is whether the rates prescribed in the Commission's order are confiscatory and therefore beyond legislative power. Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. This is so well settled by numerous decisions of this Court that citation of the cases is scarcely necessary.

Id., 262 U.S. at 690. The Court went on to reverse the West Virginia Court, holding that the return did not constitute just compensation for the use of the property used to render the service.

In a still later case the United States Supreme Court reversed a ruling of the Ohio Supreme Court affirming an order of the Ohio Public Utilities Commission fixing the rates of a gas company in Lima, Ohio. *West Ohio Gas Co. v. Public Utilities Commission of Ohio*, 294 U.S. 63 (1935). In *West Ohio Gas* the Court found that the Public Utilities Commission had reduced the return to West Ohio Gas Co. to the point of confiscation by failing to allow certain operating expenses to be reflected in rates. In reaching that decision the Court wrote: "Our inquiry in rate cases coming here from the state courts is whether the action of the state officials in the totality of its consequences is consistent with the enjoyment by the regulated utility of a

revenue something higher than the line of confiscation." *Id.*, 294 U.S. at 70. Upon concluding in *West Ohio Gas* that the return allowed was confiscatory, the Court remanded to the Ohio Commission to set compensatory rates consistent with the Constitution.

In the landmark case of *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1943), the Court established that whether or not rates are confiscatory does not depend on the particular method used to value utility plant. The Court wrote, "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the [2]Natural Gas Act is at an end." *Id.* at 602. The holding in *Hope Natural Gas* was recently reaffirmed in *Duquesne Light Co. and Pennsylvania Power Co. v. David M. Barasch*, 109 S.Ct. 609 (1989). In *Duquesne*, the Court considered a Pennsylvania law that requires that electricity rates be set without taking into account utility expenditures for facilities planned but never built, even though the expenditures were prudent and reasonable when made. The Pennsylvania Supreme Court ruled that the law did not take utility property in violation of the fifth amendment, and the United States Supreme Court agreed. The Court reiterated that, when considering whether or not a "taking" occurs in the ratemaking context, it is the total impact of the rates on the financial integrity of the company that is determinative. The individual components of the rates do not have "constitutional dimension." *Id.* at 617. The Court also referred to the concurring opinion of Justice Brandeis in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276 (1923): "Justice Brandeis accepted

the Smyth v. Ames eminent domain analogy, but concluded that what was 'taken' by public utility regulation is not specific physical assets that are to be individually valued, but the capital prudently devoted to the public utility enterprise by the utilities' owners." *Duquesne*, 109 S.Ct. at 616. Justice Brandeis' analysis of the "taking" issue in public utility law has been accepted by the Court.

Several points are clear from these cases: First, a state legislature, either directly through statute, or through a regulatory commission, can set rates that amount to a "taking" in violation of the fifth and fourteenth amendments. Second, state courts can and do review rates set by regulatory commissions to determine whether they amount to an unconstitutional "taking." Third, a state statute will not be considered an unconstitutional "taking" merely because the costs associated with compliance with the statute by regulated utilities may be disallowed by a regulatory commission. (Or, in the case of *Duquesne*, a statute that forbids a regulatory commission from passing through in rates certain reasonable costs is not an unconstitutional "taking.") It is the act of a state, normally through a regulatory commission, that denies the recovery through rates of a reasonable return on plant devoted to utility service will be determined an unconstitutional "taking."

There is no question that Mountain Water will incur certain operating expenses as a result of compliance with 69-4-511. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased. The Commission, for its part, will scrutinize all of Mountain Water's expenses to determine whether or

not they are reasonable. Reasonable expenses will be added to a reasonable rate of return on Mountain Water's rate base to arrive at the total amount of revenue (revenue requirement) that Mountain Water will be allowed to recover through rates. Once a decision is made on the revenue requirement of any regulated utility, that utility can appeal that decision to the courts. A possible basis for appeal is that the order establishing the revenue requirement constitutes a "taking" in violation of the fifth and fourteenth amendments. But the mere fact that a regulatory commission may disallow recovery of legitimate expenses associated with compliance with a statutory requirement does not render the statute to be complied with inherently unconstitutional. The potential exists that the Commission in an order could disallow legitimate costs of compliance with 69-4-511, which could *contribute* to a finding on appeal of an unconstitutional "taking." But in such a case it would be the action of the Commission that would comprise the unconstitutional "taking;" section 69-4-511 itself would not thereby be rendered unconstitutional.

Therefore, Mountain Water raises a totally false and misleading issue when it charges that 69-4-511 constitutes a prohibited "taking." The regulation of public utilities in the form of both service and rate regulation, is uncontestably within the police power of the states. *See, e.g., Munn v. Illinois*, 94 U.S. 113 (1877). Section 69-4-511, by directing private water utilities to pay for a specific service directly related to the provision of water, is inarguably a legitimate extension of state police power. Not until the Commission has acted on a water utility application that includes costs of complying with 69-4-511, will there

even be the potential for legitimately raising an issue regarding the regulatory treatment of those costs. And, as *Duquesne* makes clear, that issue will not be of "constitutional dimension" unless rates are set so as to deprive the utility of a reasonable return on its investment devoted to utility service.[12]

B. The Arguments in Section B(2) of Mountain Water's Brief are Misleading and Without Merit.

1. The Commission Recognizes that Utilities have a Right to be Compensated for the Use of their Property in the Provision of Utility Service.

Mountain Water's position on the "taking" issue reveals that it does not understand the difference between a "taking" in the context of public utility regulation, just discussed, and a "taking" as traditionally understood to require eminent domain proceedings and direct compensation. Because of this lack of understanding Mountain Water asserts that the Commission does not recognize utility property rights, and asserts that it is the theory of the Commission "that in the case of a utility, the Fifth Amendment provides no protection against the confiscation of the ownership or possession of utility property itself, but only protection of its income-producing

---

[12] The Montana Administrative Procedure Act, Mont. Code Ann. § 2-4-701 - 711, allows for the appeal of a Commission order into State district court. Appeal can then be made to the Montana Supreme Court and from there to the United States Supreme Court. The lower federal courts normally have no part in the appeal of orders from state regulatory commissions.

ability, and that utility property can be confiscated with impunity as long as future rates are somehow determined so as reflect the loss." Appellant's Brief at 29-30. This is, of course, not true.

The Commission, at the very heart of its argument, recognizes that public utilities have property rights in the assets they employ to provide utility service. It is because utilities have such rights that the courts have held that the state must allow a reasonable return on those assets or risk running afoul of the Constitution as "taking" without just compensation. The application of the fifth and fourteenth amendments on the "taking" issue makes no sense without a property right; a "taking" without compensation cannot exist absent a right in that which is "taken." Having recognized this, however, it is also necessary to recognize that the "taking" issue in public utility regulation exists in a unique context. A traditional "taking" is better characterized as a confiscation, or an expropriation: the seizing of land for the construction of a public highway or building is a good example. That is the kind of "taking" Mountain Water refers to when it writes that, "The Fifth Amendment requires either just compensation to be paid before the taking occurs, or that a later payment must include interest on the principal amount from the date of the taking . . . ". Appellant's Brief at 28. The Commission does not doubt that this is a correct statement of the law in a traditional eminent domain setting (none of the cases cited to support it deal with the regulation of public utilities). However, it has no relevance to the "taking" issue in public utility law.

One of the earliest cases that developed the "taking" issue in the special context of public utility law, and a

precursor to the cases cited by the Commission at 23-26, *supra*, is *Railroad Commission Cases*, 116 U.S. 307 (1886). In that case the Court wrote the following:

> Under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; *neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law.*

Id., 116 U.S. at 331 (emphasis added). The language, "do that which in law amounts to a taking," is an early recognition that a "taking" in the context of utility regulation, though potentially a violation of the fifth and fourteenth amendments, is a very different sort of animal than a "taking" in an eminent domain proceeding. In the latest recognition of this fact the Court wrote that the "partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment." *Duquesne*, 109 S.Ct. at 615.

Failure to understand the "taking" issue prompts Mountain Water to contend that based on "Commission theory," the state could confiscate a portion of a utility's plant and compensate the utility through rates, rather than through direct compensation. *See* Appellant's Brief at 30. This argument has nothing to do with the "taking" issue as it relates to 69-4-511, a law that does not confiscate utility plant, but rather requires a private water utility to pay part of the cost of utility service. The Commission's guess is that the courts would react to Mountain Water's argument by stating that the seizure of utility property, like the seizure of the property of any other entity or person, must be compensated for directly through an eminent domain proceeding. However, the

seizing of utility property for which direct compensation must be made, should not be confused with the directed use of utility property to provide a utility service, for which another kind of compensation must be made.

2. The Prohibition on Retroactive Ratemaking Does Not Affect the Commission's Position on the "Taking" Issue.

Mountain Water has supplied ample citation for the proposition that ratemaking is prospective and cannot provide compensation for past losses. *See* Appellant's Brief at 27. Mountain Water concludes from this that 69-4-511 is a "taking" in violation of the fifth and fourteenth amendments because compliance with it may cause Mountain Water to suffer losses that it cannot recoup. This does not follow, however, for if it did, the entire ratemaking process, as understood and practiced for over a century, would be unconstitutional. The cases have long recognized that public utilities must suffer certain losses and accept certain gains as part of regulation. No better statement of that principle is made than in *Board of Public Utility Commissioners v. New York Telephone Company*, 271 U.S. 23 (1926). In that case the New York Telephone Company applied to the New Jersey Board of Public Utility Commissioners for a rate increase. The Board investigated and found that though an increase was justified, it would be denied on the basis that excess profits had been earned based on the lawful rates previously in force. The Supreme Court reversed the Board, holding that,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, *the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations.

Id. 271 U.S. at 31-32 (citations omitted) (emphasis added). As Mountain Water acknowledges, rates are intended to reflect the estimated cost of service during the time they are effective. If that estimate is high the utility accepts the gain and a regulatory agency cannot force the utility to disgorge the gain for the benefit of future ratepayers. If the estimate is low the utility must absorb the loss and the regulatory agency cannot compensate the utility for the loss in future rates. As noted, this loss does not represent a "taking;" a "taking" occurs, in utility ratemaking, if a regulatory agency sets rates so as not to adequately compensate a utility in the future for the reasonable estimate of costs it has demonstrated it will incur based on an historic test period.

Mountain Water implies that the prohibition on retroactive ratemaking makes it impossible to recover all costs associated with 69-4-511. Even if this were true it would not mean that 69-4-511 constitutes a prohibited "taking" because it is a fact of regulation that utilities have to absorb unanticipated costs (thus reducing their rate of

return), including costs associated with government action, that are not reflected until later in rates. If, however, it turns out that initial costs associated with 69-4-511 are not recoverable, the responsibility will lie with Mountain Water management as much as with the prohibition on retroactive ratemaking. Mountain Water knew on March 24, 1987, that 69-4-511 would become effective on October 1, 1987. Mountain Water thus had more than six months to make an estimate of 69-4-511 costs and to ask that rates be effective October 1, 1988, to reflect those costs. Instead of that, Mountain Water filed this lawsuit. The Commission has not made a decision on the treatment of Mountain Water's 69-4-511 costs because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer little loss as a result of 69-4-511. If initial costs of 69-4-511 are lost as a result of the prohibition on retroactive ratemaking, this will not reflect a "taking," it will reflect the failure of Mountain Water to use the regulatory process available to it.

3. It is Misleading to Contend that Paying a Portion of the Cost of Service Line Maintenance Amounts to a Sharing of Earnings with Utility Customers.

Mountain Water writes that it "cannot fund its customers' repair and maintenance of their private property without sharing with them its earnings from its utility operations. Those earnings constitute the private property of Mountain Water, and cannot, consistent with the Fifth Amendment, be given to the Mountain Water customer . . . ". Appellant's Brief at 26. In addition to the

questionable, and in any event irrelevant, contention that 69-4-511 mandates the maintenance of private property, this statement is seriously misleading. If a utility is authorized to earn a 10 percent rate of return, and for a variety of reasons reasonable costs of providing utility service increase, causing the utility to earn only 5 percent, then the additional 5 percent return, which the utility was authorized, is forever lost to it due to the prohibition on retroactive ratemaking.[13]

Whenever a utility earns less than its authorized rate of return it is in a sense sharing some of its authorized earnings with its customers. This is so because if rates could be raised to always reflect the authorized return there would never be a difference between authorized return and actual return. But rates cannot be changed instantaneously to reflect every change in utility cost. For that reason there are times when earnings to which the utility would be entitled are left in its customers' pockets. But those potential earnings do not represent a gift to the customer from the utility, because it is not the utility's money until it is paid as a result of a lawful rate. As the Supreme Court said in *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. at 31, "The revenue paid by the customers for service belongs to the Company." Revenue not paid to the company, but which would be paid if the lawful rate allowed the company to

---

[13] As noted, however, the utility can head off this reduction in earnings if it can reasonably measure an anticipated cost in time to have higher rates in place when the cost occurs. Some costs, of course, cannot be anticipated and that is why utilities often suffer an erosion of their earnings.

earn its authorized return, does not belong to the company. Thus, whenever a utility bears legitimate costs which reduce its earnings below the authorized level, it results in a theoretical gain to the utility's customers. But this gain does not mean that there has been a "taking" of utility property because the utility never had the property to "take."

When a utility is authorized a certain rate of return, it is given the opportunity to earn that return. A utility has a property interest in the return that is earned, not in that which might have been earned. Property may, consistent with the fifth amendment and the regulatory process, be "taken" from utilities in the sense that its use is directed toward providing utility service. But that property is not given to utility customers; rather it is used to provide a service from which the customers benefit. Customers pay for that property (capital), which is "taken" (used), by paying rates which give the utility the opportunity to earn a reasonable return.

NO. 91-446

* * *

IN THE SUPREME COURT OF THE
STATE OF MONTANA

* * *

MOUNTAIN WATER COMPANY, a Montana corporation,

Plaintiff and Respondent,

vs.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL,

Defendants and Appellants.

BRIEF OF DEFENDANT-APPELLANT MONTANA PUBLIC SERVICE COMMISSION

On Appeal from the District Court of the First Judicial District of the State of Montana In and for the County of Lewis and Clark, Cause No. CDV 90-607

APPEARANCES:

For Defendants-Appellants:

Robin A. McHugh
Special Assistant Attorney General
PUBLIC SERVICE COMMISSION
1701 Prospect Avenue
Helena, Montana 59620

Mary Wright
Special Assistant Attorney General
MONTANA CONSUMER COUNSEL
34 West Sixth Avenue
Helena, Montana 59620

For Plaintiff-Respondent:

John Alke
HUGHES, KELLNER, SULLIVAN & ALKE
406 Fuller Avenue
Helena, Montana 59624-1166

B. Fifth Amendment Taking Occurs in a Special Context in Public Utility Law.

The relevant language from the fifth and fourteenth amendments follows: "No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V. "[N]or shall any state deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1. The compensation clause of the fifth amendment has been incorporated into the fourteenth amendment. *Chicago, Burlington and Quincy R.R. Co. v. City of Chicago*, 166 U.S 266 (1897), *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980). Therefore, Montana must provide compensation if it acts to take private property and such taking is deemed an exercise of the eminent domain power.[6] In the context of public utility regulation Montana, through the agency of the PSC, must allow adequate compensation through rates for the use of utility company property for the provision of utility service. Therefore, the taking of utility property for the provision of utility service is a special kind of exercise of eminent

---

[6] There can be takings under the general state police power for which there need be no compensation. These takings are not accomplished under the eminent domain power, but rather under the general rubric of business, health and welfare regulation. *See Mugler v. Kansas*, 123 U.S. 623 (1887) and its progeny; *also Yellowstone Valley Electric Cooperative, Inc. v. Ostermiller*, 187 Mont. 8, 608 P.2d 491 (1980); *and* for an excellent capsule discussion of the taking issue *see* J. Nowak, R. Rotunda, *Constitutional Law*, 2d Ed. 493 (1983) and 2 R. Rotunda, J. Nowak, J. Young, *Treatise on Constitutional Law*, § 15.12 (1986).

domain power and must be compensated under the same principle (though not in the same manner) that a property owner must be compensated if his property is taken for the construction of a highway.

The courts have long recognized the special meaning of a taking in the context of public utility regulation. In *Railroad Commission Cases*, 116 U.S. 307, 331 (1886) the Court wrote the following (emphasis added):

> Under pretense of regulating fares and freights, the state cannot require a railroad corporation to carry persons or property without reward; *neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law.*

The language, "do that which in law amounts to a taking . . . ," is an early recognition that a taking in the context of utility regulation, though potentially a violation of the fifth amendment, is different from a taking in a typical eminent domain proceeding. The Court recognized this again in *Smyth v. Ames*, 169 U.S. 466, 522-526 (1897), holding that while the State of Nebraska had the power to regulate railroad rates, it could not do so in such a manner as to amount to a taking of private property for public use without just compensation. Recently, the Court reaffirmed the special context of a fifth amendment taking in public utility law in *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989): "[The] partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment."

Later, the Court recognized "the *Smyth v. Ames* eminent domain analogy, . . . " *Id.* at 309.[7]

Therefore, while it is recognized that public utilities must expend their property to provide utility service,[8] and that this constitutes a special kind of fifth amendment taking, the questions are 1) how are utilities compensated? and 2) what constitutes just compensation? First, utilities are compensated through rates, as opposed to the direct compensation of a typical eminent domain

---

[7] The Montana Supreme Court may have obliquely recognized the special context of fifth amendment taking in public utility law. In *Yellowstone Valley Electric Cooperative v. Ostermiller*, 187 Mont. 8, 608 P.2d 491 (1980), the issue was whether a statute requiring the raising of utility lines (by regulated and unregulated utilities) to enable structures to pass, constituted an uncompensated taking. This court held that, "The statute does not involve the appropriation of a property right or a 'taking' under the laws of eminent domain in any traditional sense." *Id.* at 14, P.2d at 495. The court concluded that the statute was an exercise of the police power, necessary to preserve the public welfare, for which no compensation was due. The court recognized (or assumed), however, that compensation would come in the form of rates: "Imposing costs upon utilities and cooperatives is perhaps the most effective way of spreading the burdens created by the statute. In this way, consumers share both the burdens and the general benefits which the statute intended and is calculated to secure." *Id.* at 16, P.2d at 496. The PSC believes that *Yellowstone Valley* was correctly decided because the statute in question does not require an expenditure in the furtherance of utility service. If, however, a statute does require expenditure in the furtherance of utility service (SB 28), then it is clear that such requirement constitutes a fifth amendment eminent domain taking, though not in the "traditional sense."

[8] "Every public utility is required to furnish reasonably adequate service and facilities." § 69-3-201, MCA.

proceeding. Second, just compensation is the opportunity to earn a reasonable return on property devoted to utility service; and the rates that allow that opportunity are prospective in effect.

1. Utilities are Compensated Through Rates for the Taking of Their Property.

The proper method of compensation for a taking in the context of public utility regulation is through rates. "The district court held that Mountain Water's recourse as a utility to obtain just compensation for the property taken under [SB 28] is to seek rate increases before the PSC. We agree." *Mountain Water*, 919 F.2d at 600. The court of appeals also stated, " . . . that Mountain Water must seek just compensation through PSC rate setting rather than through an eminent domain action is not of constitutional significance." *See also Duquesne*, 488 U.S. at 307-315 (and authority cited therein).

2. Just Compensation is Achieved by Setting Rates that Give a Utility an Opportunity to Earn a Reasonable Return on Property Devoted to Utility Service.

To understand what the courts consider just compensation for a fifth amendment taking in the context of utility regulation the PSC reminds this court of the standard formula for setting utility rates: R = O + B(r). *See also* "Background to the Argument," *supra* p. 7. The "R" is the revenue requirement (sometimes referred to colloquially as the "bucket of dollars"); the "O" refers to total operating expenses; the "B" is the rate base, or the capital

investment made by the utility to provide service; and the "r" is the rate of return on capital investment that the utility has the opportunity to earn through rates.

For fifth amendment taking purposes, the only relevant question to ask about the application of this formula is whether rates are set at a level that will allow the utility the opportunity to recover its revenue requirement, which includes a reasonable return on utility investment. If the answer to that question is yes, then for purposes of the fifth amendment the inquiry is over. Subsidiary questions about the particular ratemaking treatment of certain expense or capital items are not relevant to a fifth amendment inquiry if the overall effect of the rates is just and reasonable. *Duquesne*, 488 U.S. at 310-315; *see also Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944); *see generally* Kolbe and Tye, *The Duquesne Opinion: How Much "Hope" is There for Investors in Regulated Firms?*, 8 Yale J. on Reg. 113, 114-21 (1991).

In the present case neither Mountain Water nor the district court asserted that the rates set by the PSC in Order Nos. 5449a and 5449b were not justly compensatory, on a prospective basis, to allow Mountain Water the opportunity to earn its reasonable revenue requirement.[9] Rather, Mountain Water asserted, and the district court

---

[9] As noted, a reasonable revenue requirement includes a reasonable rate of return on capital devoted to utility service. In Docket No. 89.6.23 the PSC approved a total cost of capital of 11.769 percent. Thus, Mountain Water's rates are currently set to provide sufficient revenue to cover all expenses plus a 11.769 percent return on rate base.

held, that the authorized rates constituted a taking without just compensation because they did not permit Mountain Water to recoup prior period SB 28 expenses.[10] The district court holding is clearly in error.

3. Just Compensation Through Rates Does Not Contemplate the Recovery of Prior Period Expenses (Sometimes Referred to as Past "Losses").

Ratemaking is a legislative activity and, therefore, prospective only in its effect. This court has consistently so held. *See State ex rel. Billings v. Billings Gas Co.*, 55 Mont. 102, 110, 173 P. 799, 801 (1918), "As heretofore observed, rate regulation of public utilities is distinctively a legislative function of the state, . . . "; *Billings Utility Co. v. Public Service Commission*, 62 Mont. 21, 33, 203 P. 366, ___ (1921), "It is well-settled law that ratemaking is purely a legislative act, and as such the power of the courts is circumscribed and restrained in interference with determinations reached within the scope of legislative authority."; *Montana Horse Products Co. v. Great Northern Railway*, 91 Mont. 194, 203-4, 7 P.2d 919, 923-24 (1932);

---

[10] Prior period expenses are those that are incurred prior to a PSC order (either interim or final). An order establishes new rates that are intended to recover costs, on a prospective basis, that have been determined by a review of a historic test period that includes adjustments for known and measurable changes. The new rates do not recover costs incurred prior to the order; rather, they are designed to match the costs that will occur during the period rates are in effect. *See* "Background to the Argument," *supra*, p. 7.

City of Baker v. Montana Petroleum Co., 99 Mont. 465, 482-83, 44 P.2d 735, 739 (1935),

> Certainly, under the authority to which we have already adverted, it would not be contended that an order of the commission changing the rates to be charged should operate retroactively. As we have pointed out, the charge in question was presumably one of the expense items upon which the rates were based. Hence there is no more reason for holding that an order eliminating that charge should operate retroactively than there is for holding that an order changing the rates should have retroactive effect.

Montana Citizens Freight Rate Association v. Board of Railroad Commissioners, 128 Mont. 127, 132, 271 P.2d 1024, 1027 (1954); *Cascade City Consumers Association v. Public Service Commission*, 144 Mont. 169, 192, 394 P.2d 856, 868 (1964), "This court has pointed out that it is a legislative function to regulate public utilities and that the legislature can do so through an administrative agency."; *City of Polson v. Public Service Commission*, 155 Mont. 464, 476, 473 P.2d 508, 514 (1970); *City of Helena v. Montana Department of Public Service Regulation*, 194 Mont. 173, 182, 634 P.2d 192, 198 (1981), "It is clearly the law that utilities may not set their rates so as to amortize past deficits."

The United States Supreme Court has also clearly held that rates may not recover past "losses." In *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 395 (1922) (emphasis added), the Court wrote that,

> A company which has failed to secure from year to year sufficient earnings to keep the investment unimpaired and to pay a fair return, whether its failure was the result of imprudence

> in engaging in the enterprise, or of errors in management, *or of omission to exact proper prices for its output*, cannot erect out of past deficits a legal basis for holding confiscatory for the future, rates which would, on the basis of present reproduction values, otherwise be compensatory.

Similarly, in *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23, 31-32 (1926) (emphasis added), the court held that,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, *the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations.

Also, in *Hope*, 320 U.S. 591, the Court established the standard for a fifth amendment taking in the context of public utility regulation (reaffirmed in *Duquesne*, 488 U.S. at 310). The Court wrote, "It is conceded that under the Act the [Federal Power] Commission has no power to make reparation orders. And its power to fix rates admittedly is limited to those 'to be thereafter observed and in force.' " *Hope*, 320 U.S. at 618. The Court in *Hope* did not find the prohibition against retroactive ratemaking to be inconsistent with just compensation for a fifth amendment taking. Upon such a finding the Court would have

determined the Federal Power Act unconstitutional, which it did not do. *See also Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942).

Finally, in accord with these decisions, in *Mountain Water*, 919 F.2d at 601, the court of appeals wrote, "[w]e note that utilities often in some sense share their accumulated profits with customers when utilities fail to achieve their authorized returns. Indeed, Mountain Water's 'losses' under [SB 28] are not constitutionally significant unless its set rates are 'unjust.' [*Duquesne*], 488 U.S. at 310." Thus, the court of appeals recognized that past "losses" do not raise a fifth amendment problem. A fifth amendment problem occurs only when "set" (prospective) rates are "unjust."[11]

C. Finding an exception to the prohibition against retroactive ratemaking to permit recovery of past SB 28 expenses cannot be reconciled with the law discussed above.

The district court's decision in this case, if affirmed, would not simply create an exception for prior period SB 28 expenses, it would eliminate the prohibition against

---

[11] The case law supporting the no past "losses" rule and the prohibition against retroactive ratemaking is extensive and cannot reasonably be cited here. The court is referred to the PUR Digest, 2d and 3d Series, *Rates*, § 86, and the Decennial Digests, Public Service Commissions, key 7.3, (later changed to Public Utilities, key 122). *Also, Michigan Bell Telephone Co. v. Michigan Public Service Commission*, 24 NW.2d 200 (1946) and *Pacific Telephone and Telegraph Co. v. California Public Utilities Commission*, 401 P.2d 353 (1965) are cases containing extensive discussion and citation on the issue of retroactive ratemaking.

retroactive ratemaking. If past "losses" are relevant for purposes of applying the fifth amendment taking clause to public utility regulation, then it follows, not only that there must be an exception to the rule against retroactive ratemaking, but that the fifth amendment *requires* retroactive ratemaking. The logic of the district court holding would make the ratemaking process, as understood and practiced for over a century, unconstitutional. There is obviously no legal support for such a holding.

1. There is nothing special about SB 28 expenses that requires an exception to the prohibition against retroactive ratemaking.

It is simply a fact that utilities often incur increasing costs over time that, absent additional revenues, or cost savings measures, erode earnings and make a rate increase necessary. These increased costs include a myriad of things, many of them unexpected, and over which a utility has limited control. Examples include increased taxes from changes in tax laws, fuel costs, costs to comply with government regulations of various kinds,[12] and other costs driven by general inflation. In the case of Mountain Water, electric power to run its pumps represents a significant cost. Obviously, an increase in the price

---

[12] The 1991 Montana legislature imposed a fee on water supply systems to cover certain Department of Health and Environmental Sciences costs. *See* § 75-6-108, MCA. Like SB 28 this fee represents a cost that under traditional principles of ratemaking will not be recoverable retroactively. (Municipal water systems may pass this fee through in rates automatically, but private water providers may not.)

of electricity means an increased cost of providing water service. An increased cost of electricity must be aggregated with other Mountain Water costs (offset by any increased revenues which may come from a growing customer base, and cost savings) in order to determine whether a rate increase is justified.

SB 28 has been upheld as simply another cost of providing utility service. *Mountain Water*, 919 F.2d at 601. It was governmentally imposed, but so are many other costs of providing service.[13] It was not anticipated or known as a cost of service included in Mountain Water's rates, but neither is it known what other unexpected costs will arise to erode earnings. In short, there is very little, if anything, to distinguish the "losses" imposed by SB 28 from the "losses" imposed by other unanticipated costs of service. Therefore, even if the PSC had the power to make an exception and authorize recovery of prior period SB 28 expenses in rates, there was no reasonable basis for such an exception.

---

[13] It can be argued that since utilities are required to provide adequate service, virtually all utility costs are governmentally imposed.

NO. 91-446

* * *

IN THE SUPREME COURT OF THE
STATE OF MONTANA

* * *

MOUNTAIN WATER COMPANY, a Montana corporation,

Plaintiff and Respondent,

vs.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL,

Defendants and Appellants.

REPLY BRIEF OF DEFENDANT-APPELLANT MONTANA PUBLIC SERVICE COMMISSION

On Appeal from the District Court of the First Judicial District of the State of Montana In and for the County of Lewis and Clark, Cause No. CDV 90-607

APPEARANCES:

For Defendants-Appellants:

Robin A. McHugh
Special Assistant Attorney General
PUBLIC SERVICE COMMISSION
1701 Prospect Avenue
Helena, Montana 59620

For Plaintiff-Respondent:

John Alke
HUGHES, KELLNER, SULLIVAN & ALKE
406 Fuller Avenue
Helena, Montana 59624-1166

Mary Wright
Special Assistant Attorney
General
MONTANA CONSUMER
COUNSEL
34 West Sixth Avenue
Helena, Montana 59620

THE PSC MADE NO REPRESENTATIONS IN FEDERAL COURT CONCERNING RATEMAKING TREATMENT OF PRIOR PERIOD SB 28 EXPENSES; THEREFORE, THE DOCTRINE OF JUDICIAL ESTOPPEL IS NOT RELEVANT TO THIS PROCEEDING.

Mountain Water asserts as a fact that the PSC promised (represented) in federal court to authorize the recovery of prior period SB 28 expenses in rates.[1] Further, Mountain Water asserts as a fact that the federal courts relied on this PSC "promise" when they held that SB 28 is not an uncompensated taking in violation of the fifth and fourteenth amendments to the United States Constitution. Brief of Plaintiff-Respondent at 4, 5, 7, 8 and 10. Mountain Water contends that the PSC reneged on its "promise" by refusing to authorize prior period SB 28 expenses in rates and that such refusal is unlawful as a violation of the principle of judicial estoppel. Mountain Water avers or intimates that the PSC's decision to disallow prior period SB 28 expenses in rates 1) undermines the integrity of the judicial process, 2) violates the obligation to the legal system to act fairly and above reproach, 3) amounts to playing fast and loose with the courts, and 4) is fraudulent. Brief of Plaintiff-Respondent at 10.

---

[1] Perhaps on the theory that stating a proposition makes it true, Mountain Water makes this assertion at least 11 times. *See* Brief of Plaintiff-Respondent at 1, 3, 5, 6, 7, 8, 10, 11 and 17.

A serious charge against a government agency requires a serious response – even if, as the PSC believes in this case, the charge is reckless and completely without merit. On four occasions Mountain Water has charged the PSC with reneging on a promise to allow prior period SB 28 expenses in rates: a post hearing brief, a brief in support of a motion for reconsideration, a brief to the district court on judicial review, and its brief filed in this appeal.[2] On each occasion the PSC responded carefully and conscientiously, and will do so again here. *See* PSC Order No. 5449a, appendix document (app. doc.) 10, pp. 10-14; PSC Order No. 5449b, app. doc. 11, p. 7; and PSC answer brief, Montana First Judicial District Court, app. doc. 13, pp. 5-9. (As noted, *supra* at 1, the district court did not address this issue.)

Before applying a principle of estoppel, it is first necessary to determine whether an act has occurred on which to base an estoppel. Whether or not the PSC promised to the federal courts a particular ratemaking treatment of prior period SB 28 expenses is a question of fact and the threshold issue to be determined. If it is determined that the PSC made no such promise, then it is pointless to proceed to consider the application of the legal principle of judicial estoppel.[3] Therefore, the first issue is, what did the PSC state before the federal court?

---

[2] In its post hearing brief Mountain Water argued that a decision to disallow *would* renege on a promise. In the other briefs Mountain Water argues that the PSC *has* reneged on a promise.

[3] The PSC presumes that this issue could be remanded back to district court, but contends that, for reasons of judicial efficiency, it should be decided here.

As the PSC noted in its opening brief, the only way to assess PSC communications to the federal courts is to read them. Brief of Defendant-Appellant (PSC) at 28-29. The relevant portions of the PSC's three briefs to the federal district court and brief to the court of appeals are all contained in the Joint Appendix to Briefs of Defendants-Appellants at app. docs. 4, 6, 7 and 9. It is not necessary to argue extensively from these briefs, as they clearly describe the constitutional issue and the PSC's theory of the case. The PSC will, however, respond to the specific examples given by Mountain Water and will identify certain critical language in the briefs.

Mountain Water refers to three passages in PSC briefs that it claims promise to authorize prior period SB 28 expenses in rates:

> There is no question that Mountain Water will incur certain operating expenses as a result of compliance with SB 28. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased.
>
> It is first necessary to repeat that SB 28 does not constitute an uncompensated taking. The Mountain Water Company is a public utility regulated by the PSC pursuant to Montana law. The PSC recognizes, as it must, that along with the obligation of a public utility to provide adequate service, goes the right of a public utility to be reasonably compensated for the use of its property in providing the service. SB 28, an exercise of the police power of the State of Montana, imposes a certain obligation on private water utilities. That obligation, along with others

> imposed by statute and administrative rule, can only be met through the expenditure of public utility property. For the reasonable expenditure of property, the utility must be compensated through rates paid by utility customers.
>
> The PSC, of course, defends SB 28 as a valid exercise of the state's police power for which compensation is due through rates in the special context of public utility regulation.

Brief of Plaintiff-Respondent at 3-4. These passages cannot accurately be characterized as constituting a promise to authorize prior period SB 28 expenses in rates. The first passage simply expresses the obvious point that the PSC anticipates that Mountain Water will include SB 28 compliance costs as part of its revenue requirement. The second passage is merely a summary of the PSC's argument "that SB 28 does not constitute an uncompensated taking," and a description of adequate compensation in the special context of public utility law. The third passage is yet a more succinct statement of the PSC's argument, correcting Mountain Water's mischaracterization of that argument.

None of these passages contains a promise of particular ratemaking treatment. Moreover, from all the language in the PSC's briefs on the taking issue, it is apparent that the PSC took great care not to convey a promise of particular ratemaking treatment. Consider the following passages from the three PSC briefs to federal district court: "Failure to allow the reasonable costs of compliance with SB 28 to be reflected in private water utility rates could conceivably contribute to a finding, upon review of a decision of the PSC, that those rates are

confiscatory." Opening brief, federal district court, app. doc. 4, p. 6; "With respect to SB 28, the potential exists that the PSC could disallow compliance costs which could contribute to a finding of an unconstitutional "taking." *Id.* at 13; "Not until the PSC has acted on a water utility application that includes costs of complying with SB 28, will there even be the potential for legitimately raising a 'taking' issue, or for seeking the involvement of the courts." *Id.* at 13-14;

> SB 28, like all other regulatory rules and statutes that impose costs on utilities, may be administered so as to contribute to a finding of an uncompensated taking. It is at least conceivable that the PSC, in a fit of petulance, could refuse to allow the recovery in rates of any of the reasonable costs associated with SB 28 compliance.

Answer brief, federal district court, app. doc. 6, pp. 3-4; "The question of PSC administration of SB 28 is not ripe for review because, to date, there has been no Mountain Water rate case where compliance costs with SB 28 have been an issue." *Id.* at 4; "The PSC must, consistent with the fifth and fourteenth amendments, *and consistent with accepted ratemaking procedure*, allow these costs to be reflected in rates. How this is done, and whether it has been done lawfully, are subjects of future PSC and possibly state court consideration." Reply brief, federal district court, app. doc. 7, p. 3 (emphasis added); "The PSC has not made a decision on the treatment of Mountain Water's SB 28 costs because Mountain Water has not filed an application." *Id.* at 8. Similar, if not identical passages may be found throughout the relevant parts of the PSC's brief to the court of appeals. *See* app. doc. 9.

These passages, along with all relevant parts of the PSC briefs to the federal courts, make it plain that the PSC's argument on the constitutional issue presented required no representation of particular ratemaking treatment. The PSC made no such representation in federal court; therefore, it is not necessary to consider the application of the principle of judicial estoppel. The PSC trusts that this court, upon review of the record, will reach the same conclusion.

As noted, *supra* pp. 1-2, Mountain Water also argues that the federal courts relied on promises of particular ratemaking treatment of SB 28 expenses in reaching their decisions. It is not possible to rely on a promise not given. The PSC contends that no reasonable reader of the decisions in question (including those parts of the decisions cited by Mountain Water at pp. 4-5 of its brief) could conclude that the holdings are based on a promise from the PSC of particular ratemaking treatment of SB 28 expenses. The federal courts did not rely on anything; they simply agreed with the PSC on a question of constitutional law.